

**BEFORE**  
**THE PUBLIC SERVICE COMMISSION**  
**OF SOUTH CAROLINA**  
**DOCKET NO. 2014-346-WS – ORDER NO. 2017-\_\_**

DECEMBER \_\_, 2017

IN RE: Application of Daufuskie Island Utility	)	<b>PROPOSED</b>
Company, Incorporated for Approval of an	)	<b>ORDER RULING ON</b>
Increase for Water and Sewer Rates,	)	<b>APPLICATION FOR</b>
Terms and Conditions	)	<b>ADJUSTMENTS IN RATES</b>

**I. INTRODUCTION**

This matter is before the Public Service Commission of South Carolina (the “Commission”) on remand from the South Carolina Supreme Court. This case arises from the original Application (“Application”) of Daufuskie Island Utility Company, Incorporated (“DIUC” or “the Company”) filed on June 9, 2015, seeking approval of a new schedule of rates and charges (the “Proposed Rates”) for water and sewer service that DIUC provides to its customers within its authorized service area in South Carolina. The Application was filed pursuant to S.C. Code Ann. Section 58-5-240 and 10 S.C. Code Ann. Regs. 103-712.4.A and 103.512.4.A. Petitions to Intervene were filed by the Haig Point Club and Community Association, Inc. (“HPCCA”); Melrose Property Owner’s Association, Inc. (“MPOA”); Bloody Point Property Owner’s Association (“BPPOA”) (collectively the “POAs”); and by Beach Field Properties, LLC (“Beach Field”). . The South Carolina Office of Regulatory Staff (“ORS”) was a party of record in the case pursuant to S.C. Code Ann. § 58-4-10(B) (2015).

The Commission held a hearing on the Application on October 28, 2015, and subsequently issued Order Nos. 2015-846 and 2016-50 (the “Orders”). Pursuant to S.C. Code §

58-5-240(E), the Company began collecting its Proposed Rates under bond on July 1, 2016. The South Carolina Supreme Court subsequently reversed the Orders, and remanded the case to the Commission. *Daufuskie Island Utility Company v. S.C. Office of Regulatory Staff*, 420 S.C. 305, 803 S.E.2d 280 (2017). (the “Supreme Court Opinion”).

## **II. PROCEEDINGS ON REMAND**

On December 6, 2017 the Commission, with Chairman Swain Whitfield presiding, conducted a Rehearing of DIUC’s Application beginning at 10:30 am at the Commission Hearing Room located at 101 Executive Center Drive in Columbia, South Carolina. The Rehearing continued on December 7, 2017.

DIUC was represented by G. Trenholm Walker, Esquire and Thomas P. Gressette, Jr., Esquire. The POAs were represented by John F. Beach, Esquire and John J. Pringle, Jr., Esquire. ORS was represented by Jeffrey M. Nelson, Esquire and Andrew M. Bateman, Esquire. The attorneys for Beach Field, M. John Bowen, Jr., Esquire and Margaret M. Fox, Esquire, did not attend the Rehearing.

The Transcript with Exhibits of the October 28, 2015 Hearing was made part of the record of the Rehearing as Rehearing Exhibit 2. Throughout this Order, the Commission may refer to both those exhibits introduced at the October 28, 2015 Hearing (“Hearing Exhibit ....”) and those introduced during the Rehearing (“Rehearing Exhibit ...”).

DIUC presented the testimony of: John F. Guastella<sup>1</sup> (direct and rebuttal testimony), President of Guastella Associates, LLC (“GA”), a utility management, valuation and rate

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<sup>1</sup> Rehearing Exhibit 1 consists of: 1) Guastella Direct Exhibits JFG-R1, JFG-R2, JFG-R3, and JFG-R4; and 2) Guastella Rebuttal Exhibits JFG-R5 and JFG-R6.

consulting firm headquartered in Boston, Massachusetts; and Gary C. White<sup>2</sup> (direct and rebuttal testimony), Vice President and Director of Accounting at GA. Mr. Guastella and Mr. White testified as a panel about the management and finances of DIUC.

The POAs presented a panel of witnesses, consisting of Charles E. Loy<sup>3</sup> (direct and surrebuttal) and Lynn M. Lanier<sup>4</sup> (direct and surrebuttal), Principals of GDS Associates, Inc., a utility consulting and engineering firm with its principal offices in Marietta, Georgia. POA witness Loy provided expert testimony regarding accounting and rate base issues. POA witness Lanier provided expert testimony on the overall Application and incorporated Mr. Loy's recommended adjustments. Beach Field did not pre-file or present testimony or cross examine any witness at the Commission hearing.

ORS presented the testimony of Douglas H. Carlisle<sup>5</sup> (direct), ORS Economist; Daniel F. Sullivan<sup>6</sup> (direct and surrebuttal), Deputy Director of the ORS Audit Department; and Dawn M. Hipp<sup>7</sup> (direct and surrebuttal), Director of the Utility Rates and Services Department of the ORS. Dr. Carlisle's testimony (which adopted his direct testimony and exhibits filed on October 2, 2015 and provided at the Hearing on October 28, 2015 included an analysis and recommendation

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<sup>2</sup> Rehearing Exhibit 3 consists of: 1) White Direct Exhibit GCW-R1; and 2) White Rebuttal Exhibit GCW-R2.

<sup>3</sup> Rehearing Exhibit 5 consists of Loy Direct Exhibits CEL-1, CEL-2, CEL-3, CEL-4, CEL-5, and CEL-6.

<sup>4</sup> Rehearing Exhibit 6 consists of Lanier Direct Exhibits LML-R3, LML-R4, LML-R5, LML-R6, and LML-R7. Rehearing Exhibit 7 is Lanier Surrebuttal Exhibit LML-R8.

<sup>5</sup> Dr. Carlisle's Rehearing Testimony did not include any new exhibits, but his Hearing Exhibit 17 contains Carlisle Direct Exhibits 1 through 10.

<sup>6</sup> Rehearing Exhibit 8 is Sullivan Direct Exhibits DFS-1 through DFS-9. In addition, Mr. Sullivan adopted the prefiled testimony and exhibits of Ivana C. Gearheart from the Hearing. Accordingly, Hearing Exhibit 18 is Gearheart Direct Exhibits 1 through 8.

<sup>7</sup> Rehearing Exhibit 9 consists of: 1) Hipp Direct Exhibits DMH-1 through DMH-5; and 2) Hipp Surrebuttal Exhibit DMH-1. In addition, Ms. Hipp adopted the prefiled testimony and exhibits of Mr. Willie J. Morgan from the Hearing. Accordingly, Hearing Exhibit 19 is Morgan Direct Exhibits 1 through 8, and Hearing Exhibit 20 is Morgan Surrebuttal Exhibits 1 and 2.

for an return on equity (“ROE”), capital structure, and rate of return on Rate Base. Mr. Sullivan’s testimony (which adopted the prefiled testimony and exhibits of Ivana C. Gearheart from the Hearing) described ORS’s examinations of the application and DIUC’s books and records as well as the subsequent accounting and pro forma adjustments recommended by ORS. Ms. Hipp’s testimony (which adopted the prefiled testimony and exhibits of Mr. Willie J. Morgan from the Hearing) focused on DIUC’s compliance with Commission rules and regulations, ORS’s business audit of DIUC’s water and wastewater systems, test-year and proposed revenue, and performance bond requirements.

### **III. THE EFFECT OF THE SUPREME COURT OPINION**

The Supreme Court Opinion reversed the Orders, concluding that the “Commission erred in admitting into evidence and adopting the Settlement Agreement between ORS and the POAs,” stated it was “remanding for a new hearing on all issues,” and remanded the case to the Commission “for a de novo hearing.” *Daufuskie Island Util. Co.*, 420 S.C. 305, 320, 803 S.E.2d 280, 288. In addition, the South Carolina Supreme Court purported to provide the Commission with “guidance” on three issues: 1) “Rate Base Includes Elevated Tank Site”; 2) “Property Tax Expense”; and 3) “Bad Debt Expense.” *See Daufuskie Island Util. Co.*, 420 S.C. 305, 316-320 803 S.E.2d 280, 286-288.

The Commission reads the term “de novo” clearly and plainly to mean that Rehearing ordered by the Supreme Court allowed the parties to present testimony and documentary evidence, and make arguments, about any matter at issue in this Docket. Significantly, the Supreme Court specifically overturned *Parker v. South Carolina Public Service Commission*, 288 S.C. 304, 307, 342 S.E. 2d 403, 405 (1986), “to the extent that it holds the Commission may

consider new evidence on remand only if explicitly authorized to do so by an appellate court.”

*Daufuskie Island Util. Co.*, 420 S.C. 305, 316, 803 S.E.2d 280, 286 at Fn. 8. Therefore, the parties were free to submit whatever evidence and make arguments in support of their respective positions.

With respect to the Supreme Court’s “guidance,” the Commission does not construe that “guidance” to mandate a particular result on remand. With respect to these three issues (and all issues before the Commission in this case), the Commission must render a decision supported by substantial evidence and consistent with applicable South Carolina law. In other words, while the Supreme Court Opinion’s “guidance” may suggest what the Commission cannot do on remand, it most certainly does not mandate a particular result with respect to those three issues or any issue before the Commission in this Docket.

#### **IV. REVIEW OF THE EVIDENCE AND EVIDENTIARY CONCLUSIONS**

##### **Standards and Required Findings**

DIUC’s Application was filed pursuant to S.C. Code Ann. Sections 58-5-210 and 58-5-240 and 10 S.C. Code Ann. Regs. 103-712.4.A and 103.512.4.A. In considering the Application, the Commission must ascertain and fix just and reasonable rates, standards, classifications, regulations, practices, and measurements of service to be furnished. Thus, the Commission must give due consideration to the Company’s total revenue requirements and review the operating revenues and operating expenses of DIUC to establish adequate and reasonable levels of revenues and expenses. The Commission will consider a fair rate of return for DIUC based on the record and any authorized increase in revenue and rates must be just and reasonable and free

of undue discrimination. DIUC has also asked this Commission to establish revenues based on an authorized ROE which is established to allow DIUC the opportunity to earn a fair return.

After discussion of the positions of the parties, the Commission reaches the legal and factual conclusions below based on its review of the facts and evidence of record.

The evidence supporting the Company's business and legal status is contained in the Application filed by DIUC, testimony, and in prior Commission Orders in the docket files of the Commission, of which the Commission takes judicial notice. This finding of fact is informational, procedural and jurisdictional in nature, and the matters which it involves are not contested by any party.

#### Test Year

With respect to the test year, DIUC utilized a historic test year – the twelve months ending December 31, 2014 with adjustments. ORS used the 2014 historical test year for two reasons: 1) because it was chosen by DIUC and 2) the underlying transactions in the 2014 books could be tested to ensure that the transactions were adequately supported, had a stated business purpose, were allowable for ratemaking purposes, and were properly recorded. Consistent with past practice and in accordance with generally accepted regulatory principles and prior Commission orders, ORS adjusted, as necessary, the revenues, expenses, and capital investments to normalize the Company's operating experience and rate base. The POAs also utilized a 2014 historic test year with adjustments.

A fundamental principle of the ratemaking process is the establishment of a historical test year as the basis for calculating a utility's operating margin or, in this case, a return on rate base, and, consequently, the amount of the utility's requested rate increase. In order to determine what

a utility's expense and revenues are for purposes of determining the reasonableness of proposed rates, one must select a 'test year' for the measurement of the expenses and revenues. *Heater of Seabrook v. Public Service Commission of South Carolina*, 324 S.C. 56, 478 S.E.2d 826, 828 n.1 (1996). While the Commission considers a utility's proposed rate increase based upon occurrences within the test year, the Commission will also consider adjustments for any known and measurable out-of-test year changes in expenses, revenues, and capital investments, and will also consider adjustments for any unusual situations which occurred in the test year. Where an unusual situation exists which shows that the test year amounts are atypical, the Commission should adjust the test year data. *See Southern Bell v. The Public Service Commission*, 270 S.C. 590, 244 S.E. 2d 278 (1978); *see also, Parker v. South Carolina Public Service Commission*, 280 S.C. 310, 313 S.E.2d 290 (1984), *citing City of Pittsburgh v. Pennsylvania Public Utility Commission*, 187 P.A. Super. 341, 144 A.2d 648 (1958); *Southern Bell v. The Public Service Commission*, 270 S.C. 590, 244 S.E.2d 278 (1978). Based on the information available to the Commission and that all parties agreed to a 2014 test year, the Commission is of the opinion, and therefore concludes, that the test year ending December 31, 2014 is appropriate for the purposes of this rate adjustment request.

#### Rate of Return on Rate Base

DIUC requested that its rates be determined in accordance with the rate of return on rate base methodology. The determination of rate of return on rate base requires three components: 1) capital structure; 2) cost of debt; and 3) cost of equity (or return on equity). However, by statutory requirement, the Commission must also specify an allowable operating margin in all water and wastewater orders. Although the Commission must specify an operating margin in its

order, this does not mean that the operating margin methodology must be used in determining a fair rate of return. *Heater of Seabrook* at p. 64 and 830. Operating margin “is less appropriate for utilities that have large rate bases and need to earn a rate of return sufficient to obtain the necessary equity and debt capital that a larger utility needs for sound operation.” *Id.* No party contested the use of the rate of return on rate base methodology and given DIUC’s large rate base, the Commission finds the rate of return on rate base methodology appropriate in this case.

#### Capital Structure and Cost of Debt

With respect to the capital structure, DIUC recommended a pro forma capital structure of 41.2% debt and 58.8% equity. ORS witness Dr. Carlisle testified there are two concerns with the method DIUC used to calculate its capital structure: 1) DIUC included pro-forma long-term debt in its long-term debt calculation; and 2) DIUC proposed an inflated equity amount. (Carlisle Direct R. p. 472). Dr. Carlisle noted that both result in an increase in the ROE. (*Id.*) The pro forma debt is based on the cost of debt DIUC expects, and as Dr. Carlisle noted, the outcome of DIUC’s negotiations with banks or lenders is unknown at this time; therefore, DIUC’s pro forma debt should not be included. (Carlisle Direct, R. p. 473). The POAs also agreed that debt should not include future amounts. (Lanier Direct, R. p. 436, ll. 8-14). Dr. Carlisle further testified that DIUC’s capital structure is weighted more heavily with equity, which is more expensive than debt. (*Id.*) In contrast to a projected or pro forma capital structure, ORS recommended a hypothetical capital structure of 46% long-term debt and 54% equity calculated by averaging the known capital structure used by water companies in the United States with publicly traded stock. (*Id.*) The POAs produced an adjusted capital structure of 57.55% debt and 42.45% equity



(Hearing Exhibit 14, Amended Lanier Exhibit 3), based on a downward adjusted rate base, which is discussed later in this Order.

As to the specific cost of debt rate, DIUC recommended 6.20%. The POAs testified that 6.20% is relatively high in the current interest rate environment, but is probably a reasonable rate given DIUC's precarious financial state. In the Rehearing, the POAs adopted the capital structure and debt and ROE proposed by ORS. To calculate the 6.20% debt rate, DIUC included anticipated legal and GA fees in the financing fees. In support of the debt amount, Mr. Guastella testified the debt he used is based on his knowledge of prior financing costs applied to the costs expected to be incurred for future refinancing. As a percentage of the total debt, the anticipated fees are 13.56% per ORS's calculations. ORS did not incorporate the additional fees into the debt rate because the fees are a large percentage of the total debt and did not originate from a lending institution. ORS recommended that the actual debt rate being paid by DIUC to the current lending institution, 5.29%, be used.

However, for the rehearing, the POAs Adopted the ORS recommended capital structure, debt rate and ROE rate. (Lanier Rehearing Direct, R. pp. 377-378, and schedules C-3, W-3, and S-3 in exhibits LML-R3, R4, (Rehearing Exhibit 6) and R8 (Rehearing Exhibit Seven)). In its revised Schedules in Support of a Rate Increase (Exhibit GCW-R1, pages 9, 27, and 46) (Rehearing Exhibit 3), DIUC revised its capital structure to 53.8% debt and 46.2% equity, revised the debt rate from 6.2% to 5.75%, but retained the 10.5% ROE rate, resulting in a calculated Rate of Return (ROR) of 7.75% vs 8.73% from the original application.

Upon consideration of the evidence, the Commission adopts the capital structure, 46% long-term debt and 54% equity, and debt rate, 5.29%, recommended by ORS since they are based on known data instead of expected events.

Cost of Equity/Return on Equity

DIUC witness Guastella testified that the requested 10.5% ROE is based on his experience and judgment. The POAs witness Lanier testified in his direct testimony in the Hearing, “This is the same rate the Company requested in its 2012 rate case<sup>8</sup>, which was a specified rate, rather than a rate developed through justification of the ROE required to meet its needs for profit margin and to attract the needed debt capital.” (Lanier Rehearing Direct, R. p. 437, ll. 1-4). In contrast to DIUC, ORS’s Dr. Carlisle recommended an ROE of 9.31% based on a range of 8.91% to 9.71% using results from the Discounted Cash Flow model (“DCF”), Capital Asset Pricing Method (“CAPM”) and the Comparable Earnings Model (“CEM”). (Carlisle Direct R. pp. 471 and 474). Dr. Carlisle testified the DCF and CAPM are known and generally accepted methods for determining a recommended ROE. (Id.) The POAs testified in the Hearing that the DCF is the prevailing method used for determining appropriate ROEs. The POAs also testified that while the DCF and CAPM are recognized as methods for calculating ROEs, the DCF and CAPM provide challenges since there are not many publicly traded companies similar to DIUC. For his analyses, Dr. Carlisle examined data on companies with publicly traded stock of which more data is available, because DIUC requested rates based on rate of return. (Carlisle Direct R. p. 475). Companies with publicly traded stock yield more data than what is available for privately held companies. (Id.) Specifically, Dr. Carlisle testified that

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<sup>8</sup> The merits hearing for DIUC’s last rate case in Docket No. 2011-229-WS was held in 2012.

he used publicly traded companies classified as “water utilities” by Value Line or *Yahoo! Finance* for his DCF and CAPM since they are in the same line of business as DIUC and share similar risks. (Id.) For his CEM analysis, Dr. Carlisle used companies with comparable betas to those of the companies used in his DCF and CAPM group. (Id.)

DIUC did not provide analyses similar to those used by Dr. Carlisle; however, Schedule A-3 of DIUC’s application shows the following references to ROE:

Connecticut DPUC Formula:

Average Large Company	9.69%
Small Company Adder	0.50%
Performance Adder	<u>0.50%</u>
	<u>10.69%</u>

Florida PSC Leverage Graph Formula:

5.6% + (2.279 / Equity Ratio)	= ROE
Range	100% = 7.88%
	40% = 11.30%
Equity Ratio	58.8% = <u>9.47%</u>

There is no discussion of these components in Schedule A-3 or testimony, with the exception of Mr. Guastella’s rebuttal testimony from the Hearing containing the following single sentence, “Under the Connecticut Public Utilities Regulatory Authority formula for return on equity for small companies, the rate of return on equity for DIUC is 10.69%.” ORS provided no testimony on either the Connecticut or Florida ROE formulas. The POAs could find no other reference to the Connecticut formula and challenged DIUC’s portrayal of the Florida formula. Witness Lanier for the POAs testified, “[S]imply including a formula on a schedule and a calculated number is not sufficient rationale to support a ROE, particularly of 10.5%, when the company is requesting a revenue increase of over 100% in order to achieve such return.” (Lanier Rehearing Direct, R. p. 439, ll. 7-9). The POAs acknowledged Dr. Carlisle as a source to

support an appropriate ROE, and the POAs pre-filed direct testimony in the Hearing recommended an ROE in the range of 8.5% to 9.0% in consideration of a lower rate base and based on various examples of DIUC's "irresponsibility in its operations since the rate increase authorized in 2012 and in the use of debt funds, in view of the critical need for cash." (Lanier Rehearing Direct, p. 441, ll. 2-3).

As noted above, for the rehearing, the POAs Adopted the ORS recommended capital structure, debt rate and ROE rate and DIUC revised its capital structure to 53.8% debt and 46.2% equity, revised the debt rate from 6.2% to 5.75%, but retained the 10.5% ROE rate.

In summary, DIUC requested an ROE of 10.5%; ORS recommended an ROE of 9.31% based on a range of 8.91% to 9.71%; and the POAs adopted the ORS-recommended ROE.

Upon consideration of the various witnesses, the Commission adopts the range set forth in evidence as produced by ORS. ORS used the well-known and commonly-accepted DCF method, CAPM, and CEM for developing its range of 8.91% to 9.71%. Those methods, as applied by ORS, are grounded in sound analysis and have been adopted by the POAs. The Commission finds DIUC's ROE recommendation of 10.5% lacking in support and analysis.

#### Rate Base

As a threshold matter, none of the parties excluded the Elevated Water Tank from rate base on Rehearing, so neither that issue, nor the Supreme Court Opinion's guidance on that topic, is being litigated in the Rehearing.

DIUC proposed a rate base for combined operations of \$6,975,242. (Exhibit GCW-R1) (Rehearing Exhibit 3). ORS proposed a rate base for combined operations of \$5,867,632. (Revised Rehearing Audit Exhibit DFS-1) (Rehearing Exhibit 8).

With respect to the overall rate base, the POAs recommended that DIUC's rate base as proposed be reduced to \$2,304,944. This reduction resulted from a combination of 1) classifying donated plant as contributions in aid of construction ("CIAC") and 2) applying straight line depreciation to the Company's plant investment, thereby increasing accumulated depreciation and reducing net plant. (LML-R3, Schedule C-2) (Rehearing Exhibit 6).

Simply applying straight-line depreciation to the Company's plant causes an increase in accumulated depreciation and a corresponding decrease in net plant. This adjustment alone reduces combined rate base to \$4,613,231. (Exhibit LML-R8, Schedule C-2) (Rehearing Exhibit 7).

*Donated Plant as CIAC*

The POAs assert that DIUC has "no original costs in a large portion of its Utility Plant because that Plant was donated to DIUC by Haig Point, Inc., the developer of Haig Point." (Loy Rehearing Direct, R. p. 309 ll. 20-21). As shown on Loy Exhibit CEL-R1 (Rehearing Exhibit 5), Haig Point Utility Company, Inc. ("HPUC") (the previous name of DIUC) showed "Plant in Service" of \$4,339,598 on its Combined Balance Sheet in support of its rate case before this Commission in Docket No. 2005-34-WS. However, this "Plant in Service" amount was an adjustment to the Company's "Property, Plant and Equipment" balance of \$0.0 as of "Total Year Ended 6/30/04" as shown on its Trial Balance (Loy Exhibit CEL-R2, Rehearing Exhibit 5). Mr. Loy testified that HPUC's Water Annual Reports for the years 2000-2003 showed no plant

balances at all. (Loy Rehearing Direct, R. p. 381). According to the POAs, this “zero balance” for Plant in Service on June 30, 2004 demonstrates that Haig Point, Inc. donated the Plant in Service to DIUC, as do the deeds and conveyances through which Haig Point, Inc. transferred the land and property comprising water and sewer plant to DIUC “for no consideration.” (Loy Exhibit CEL-R3) (Rehearing Exhibit 5).

Moreover, International Paper (IP), the owner of Haig Point, Inc. disclosed in its 1999 SEC Form 10-K (at Exhibit One, Note C), that it wrote off its entire Haig Point investment in 1997. (The 1999 IP Form 10-K was an Exhibit to Mr. Loy’s Surrebuttal Testimony in the Hearing). And the financials associated with HPUC’s initial rate case before this Commission in Docket No. 87-333-W/S show that the rates established by HPUC – and that were in place until 2005 – only recovered the operating costs (as opposed to the capital costs associated with Plant, Property and Equipment) of the Utility. According to the POAs, these factors demonstrate that this particular Utility Plant was donated to DIUC by Haig Point, Inc. Finally, the purchase price for the stock of HPUC (\$1.75 million) paid by CK Materials, LLC in 2008 is much lower than the plant value claimed by HPUC/DIUC. (Exhibit CEL-R6) (Rehearing Exhibit 5).

According to the POAs, and contrary to NARUC Uniform System of Accounts (“USoA”), Accounting Instruction 18, “*Utility Plant – To Be Recorded at Cost*” Part D, DIUC erroneously booked the donated “Property Plant and Equipment” by crediting “Paid-in Capital” (Note 8 of Loy Exhibit CEL-R2, Rehearing Exhibit 5) instead of Contributions in Aid of Construction (CIAC). The NARUC USoA requires that entries to utility plant accounts for plant donated to the utility must be offset by credits to CIAC. As set out in Mr. Loy’s Rehearing Direct Testimony (Rehearing R. p. 312, ll. 4-17), NARUC USoA, Accounting Instruction 18,

“Utility Plant - To be Recorded at Cost” Part D describes how the values of the donated plant should have been initially booked. Part D states:

Utility plant accounts shall be charged with construction costs (estimated, if not known) of the utility plant contributed by others or constructed by the utility using contributed cash or its equivalent. For contributed utility plant, the accumulated depreciation or amortization account shall be charged with the estimated amount of depreciation or amortization applicable to the property at the time it was contributed to the utility. Account 271 - Contributions in Aid of Construction shall be credited with the net of the amounts charged to the plant and the accumulated depreciation or amortization accounts. For plant constructed using contributed cash or its equivalent, account 271 - Contributions in Aid of Construction shall be credited with the amount of the cash or its equivalent contribution.

NARUC defines CIAC as “[a]ny amount or item of money, services or property received by a utility, from any person or governmental agency, **any portion of which is provided at no cost to the utility**, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition improvement or construction costs of the utility’s property, facilities, or equipment used to provide utility services to the public. (emphasis added). NARUC Section 271(A). (Loy Rehearing Direct, R. p. 312, ll. 18-26).

DIUC witness Guastella admitted in the Rehearing (Rehearing R. p. 50-51) that HPUC did not pay anything in exchange for the plant assets in question. Mr. Guastella, nevertheless, asserts that the manner in which the plant assets in question were transferred from Haig Point to HPUC and booked by HPUC was customary in his experience. Mr. Guastella described the process as follows: “And the way it’s established is all of the construction costs and the utility assets that had to be paid for by the developer [Haig Point], because the utility [HPUC] was a paper corporation and no revenues, no ability to finance it, and those facilities were turned over

to the utility [HPUC] and they're turned over as an investment by the developer [Haig Point, Inc.] in the form of an equity investment in the utility [HPUC]. It doesn't ask the utility to pay for the utility facilities." (Rehearing R. p. 51, ll. 15-24). Mr. Guastella also testified that the treatment of the plant assets in question as proposed by the POAs "would end the utility" because DIUC would not be able to obtain financing. (Rehearing R. p. 52).

In addition, Mr. Guastella claims in his Rehearing Rebuttal Testimony (Rehearing R. pp. 101-103) that various Commission Orders and proceedings, as well as the positions that the parties in those cases (e.g. the POAs and ORS) have taken or not taken, support rejecting the POAs' proposed adjustments to net plant and therefore rate base.

The testimony of the ORS witnesses does not specifically adopt or support the POAs' treatment of utility plant as donated plant/CIAC, but ORS witness Hipp testified that approach is reasonable and consistent with generally accepted ratemaking principles. (Rehearing R. p. 494 ll. 18-24, p. 495, l.1).

#### Commission Decision

After reviewing the evidence and arguments presented by DIUC, ORS, and the POAs, the Commission accepts the rate base determination methodology and adjustments proposed by the POAs. The POAs have offered compelling testimony and evidence that DIUC did not pay for that portion of its Utility Plant that was placed on its books as an adjustment in 2004. As such, the Utility Plant in question squarely meets the definition of "contributions in aid of construction" as that term is used by NARUC:

"[a]ny amount or item of money, services or property received by a utility, from any person or governmental agency, **any portion of which is provided at no cost to the utility**, which represents an addition or transfer to the capital of the utility,



and which is utilized to offset the acquisition improvement or construction costs of the utility's property, facilities, or equipment used to provide utility services to the public. (emphasis added). NARUC Section 271(A).

The Utility Plant in question was provided to HPUC by Haig Point at no cost to HPUC. Accepting for the sake of argument that Mr. Guastella's contention that the Utility Plant in question was "turned over as an investment by the developer [Haig Point, Inc.] in the form of an equity investment in the utility [HPUC]" were true, there is no evidence that HPUC paid anything to Haig Point, Inc. in exchange for that "investment." In fact, the evidence provided by the POAs shows just the opposite. And Mr. Guastella himself conceded that HPUC did not pay Haig Point for the Utility Plant.

The Commission is not convinced by Mr. Guastella's contentions in his Rebuttal Testimony (Rehearing R. pp. 101-103) that current and previous Commission and/or ORS decisions or positions establish that the Commission cannot or should not reclassify assets as CIAC for purposes of establishing rate base. No previous Commission Order has foreclosed the POAs' ability to challenge the rate base proposed by DIUC, and DIUC simply has put forth no evidence or argument supported by any legal or regulatory authority that the assets in question are not donated plant that should have been classified as CIAC.

Finally, the Commission finds Mr. Guastella's testimony regarding the fate the Company would face were the Commission to accept these adjustments as speculative at best. Moreover, those contentions do not address or refute the proposition put forth by the POAs (and unrefuted by DIUC) that the Utility Plant in question was donated and appropriately treated as CIAC.

Accumulated Depreciation

POAs' witness Mr. Loy testified that, contrary to the practices of DIUC, "the full straight-line depreciation must be recorded to *accumulated* depreciation in order to comply with NARUC and rate making guidelines." (Loy Rehearing Direct, Rehearing R. p. 321, ll. 9-10). As cited in Mr. Loy's testimony, the NARUC Uniform System of Accounts ("USoA") requires straight-line depreciation over the useful life of plant in service:

*"Straight-line method" as applied to depreciation accounting means the plan under which the service value of property is charged to operating expenses (and to clearing accounts if used), and credited to the accumulated depreciation account through equal annual charges during its service life. Estimates of the service life and salvage will be reexamined periodically and depreciation rates will be corrected to reflect any changes in these estimates.*

DIUC, however, is depreciating its plant according to its "Complete System" methodology, which calculates depreciation expense based on the percentage of customers currently using the system relative to the total number of customers at system capacity. This results in depreciation expense calculated based on 47% of water plant and 35% percent of the sewer plant. (Rehearing Direct Testimony of Charles Loy, R. p. 319, ll. 7-8). As a result, only part of the depreciation expense that represents the useful life is expensed and placed into accumulated depreciation on the books of the Company. (Loy Rehearing Direct, R. p. 329, ll. 10-11). In addition, Mr. Loy testified that an adjustment increasing accumulated depreciation "reflects the proper age and condition of the utility property," (Loy Direct, R. p. 371).

As a result, and as shown in Exhibit LML-8, Schedule C-1 (Rehearing Exhibit 7), the calculation of "straight-line" accumulated depreciation results in a total amount of accumulated depreciation of \$3,055,943, which reduces DIUC's combined net plant for rate base to \$5,083,318.

The testimony of the ORS witnesses does not specifically adopt or support the POAs' application of straight-line depreciation and its effect on accumulated depreciation.

DIUC did not offer any specific testimony or evidence in opposition to the adjustments to accumulated depreciation proposed by the POAs, other than the fact that its proposal offered a different figure for accumulated depreciation.

#### Commission Decision

The Commission adopts the proposal of the POAs to adjust accumulated depreciation as set out in Exhibit LML-8, Schedule C-1 (Rehearing Exhibit 7). The NARUC USoA requires full straight-line depreciation expense to be recorded to accumulated depreciation. DIUC's failure to do so is also inconsistent with the NARUC publication "Public Utility Depreciation Practices," which states:

It is essential to remember that depreciation is intended only for the purpose of recording the periodic allocation of cost in a manner properly related to the useful life of the plant. It is not intended, for example, to achieve a desired financial objective or to fund modernization programs.

Neither DIUC nor ORS witnesses provided any testimony suggesting that unutilized plant does not lose service value over time, or even that unutilized plant loses service value over time at a slower rate than used and useful plant. The Commission is particularly concerned with the information set out in Mr. Loy's Table Four (Loy Rehearing Direct, R. p. 322, l. 5), which shows that DIUC's proposed accumulated depreciation in this case (\$777,854) is 57% *lower* than that approved by the Commission in Docket 2005-34-W/S. Any benefits to DIUC customers in the form of lower depreciation rates are outweighed by the effects of lower accumulated

depreciation on return and taxes (Loy Table 3, Loy Rehearing Direct, R. p. 320, l. 11). For these reasons, the Commission adjusts accumulated depreciation as proposed by the POAs.

#### Utilization Factors

POA witness Loy offered an alternative approach in his Rehearing Direct Testimony. (Rehearing R. pp. 324-330). DIUC's rate base must be adjusted to reflect the level of plant that is actually in service. In the 2005 rate case, ORS applied this concept in its recommendations in its Audit Report<sup>9</sup>. ORS proposed removing "plant in service based on most recent system utilization factors of 40.94% for water and 34.16% for sewer".<sup>10</sup> The utilization factors were developed by the Company to identify the portion or percentage of the water and sewer systems that are "used and useful". In the 2005 Rate Case test year, the utility was serving only 40.94% of the potential customers its water system could serve, and only 34.16% of the potential customers its sewer system could serve. ORS applied the utilization factors to the Company's proposed plant by these percentages, which resulted in a \$2,277,603 reduction in that component of DIUC's rate base.

According to Mr. Loy, this approach follows the key rate making concept of "used and useful," and his proposed adjustment assures that a utility's customers do not bear the economic burden of excess capacity and possibly a developer's imprudent decision to overbuild a water or sewer system. As Mr. Loy explained, a developer has the ability to either construct a utility system in phases, as the development proceeds, or construct a much larger system initially - one that could serve the entire development, if and when it is entirely built-out. Here, the developer

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<sup>9</sup> See Docket No. 2005-34-W/S, Testimony of Sharon G. Scott, p 24, Audit Exhibit SGS-11, relevant portions included in **Exhibit CEL-R5, Rehearing Exhibit 5**.

<sup>10</sup> See *Id.*, Note (G) to ORS Audit Exhibit SGS-11 in **Exhibit CEL-R5, Rehearing Exhibit 5**.

decided to initially build a system large enough to serve a fully-built out Haig Point development, before determining whether the development would even be a success. (Rehearing R. p. 325).

In 2004, roughly twenty years after development of the Haig Point community began, system utilization was only 41% (water) and 34% (sewer). ORS's proposal to reduce the utility's gross plant to these actual utilization percentages ensured that current customers did not bear an undue economic burden otherwise caused by the developer's decision to construct such a large system at the beginning of the development. (Rehearing R. p. 325).

System utilization has not changed materially in the last 12 years. Since 2004, the water system utilization has increased from 41% to 47% and sewer system utilization has increased from 34% to 35%. This essentially immaterial growth in system utilization over the twelve years period demonstrates that the developer grossly overbuilt the water and sewer systems when it began developing Haig Point in the 1980s. Including all the plant in Rate Base, as proposed by DIUC, would unfairly burden DIUC's customers and unfairly compensate DIUC. DIUC should not be allowed to charge rates that cause DIUC's customers to bear the burden of the developer's initial decision to build out the entire system when future success of the development was unknown. (Rehearing R. p. 326).

The adjustment follows the well-known rate making concept that only plant that is "used and useful" should be included in rate base. Numerous authoritative texts on utility ratemaking cite this principle or rule. For example, "Accounting for Public Utilities" by Robert L. Hahne, states:

“Only plant currently providing service or capable of providing utility service to the consuming public is allowed in rate base.”

“The Regulation of Public Utilities” by Charles F. Phillips Jr. states:

“For decades, used and useful referred to needed capacity; that is, a determination as to whether a plant was actually used in service and was useful in providing service.”

“Principles of Water Rates, Fees, and Charges” also known as the “Manual of Water Supply Practices M1” published by the American Water Works Association states:

“The primary issue related to including plant in the rate base is whether the plant is used and useful in providing utility service.”

Further, the 2005 ORS adjustment agrees with the “Rate Case and Audit Manual” developed by NARUC to assist utility commission staffs with rate case audits which states:

“In reviewing specific rate base items, the auditor will want to continually be considering the concept of used and useful. This principle is widely adopted by regulatory commissions and requires that plant be functioning and necessary to be included in the revenue requirement. Plant that is considered to be excessive may not be appropriate for inclusion in rates at this time.” (Emphasis added).

According to Mr. Loy, the same factors supporting ORS’s proposed adjustment in 2005 apply today with even more force. As discussed above, customer growth over the last twelve years has been materially insignificant. Like in 2005, DIUC’s system today is largely unutilized. Table 8 (Rehearing R. p. 328) shows how the booked plant values must be reduced to reflect actual utilization and demonstrates how that reduction is computed.

DIUC does not agree with the POAs’ plant utilization approach. The testimony of the ORS witnesses does not specifically adopt or support the POAs’ plant utilization adjustment, but

ORS witness Hipp testified that approach is reasonable and consistent with generally accepted ratemaking principles. (Rehearing R. p. 495 ll. 8-13).

#### Commission Decision

Because the Commission is accepting the POAs' recommendation to reclassify DIUC's donated plant from paid-in capital to Contributions in Aid of Construction, we decline to adopt their alternative "used and useful" adjustment to rate base. Although the Commission finds the ratemaking principles supporting this adjustment to be sound, the vast majority of the proposed adjustments would be made to the plant that was originally donated to the utility. The Commission's decision to remove donated plant entirely from rate base makes this proposed alternative unnecessary.

#### Rehearing Accounting and Pro Forma Adjustments

The parties offered various revised rehearing accounting and pro forma adjustments based upon the Opinion. Those adjustments as proposed by DIUC and the Company are set out in Revised Rehearing Audit Exhibit DFS-4 (Rehearing Exhibit 8). The Commission adopts those adjustments with which no party disagreed as just and reasonable, and proceeds below to consider those adjustments upon which the parties could not agree.

#### Management Fees

DIUC proposed management fees of \$171,365. (Exhibit GCW-R1) (Rehearing Exhibit 3).

ORS proposes to adjust outside management fees to \$132,211, an amount which was approved by the Commission in Docket No. 2011-229-WS. This results in an adjustment of

(\$25,439) to the original per book amount of \$157,650, and an adjustment of (\$39,154) to the amount of \$171,365 proposed by DIUC in Rehearing Exhibit 3.

The management fees sought by DIUC are described in a Management Agreement with Guastella and Associates, Inc. (“GA”). (Hearing Exhibit 9); and (Exhibit DMH-4) (Rehearing Exhibit 9). Through the Management Agreement, DIUC, its parent company, Daufuskie Island Holding Company, LLC, (“DIUC Holding Company”), and DIUC Holding Company’s stockholders (together “Clients”) delegated to GA the authority to act on behalf of the Clients and for the benefit of DIUC. (Hipp Rehearing Direct, R. p. 477, ll. 9-13). Ms. Hipp testified that the services provided to DIUC did not increase during the test year from those provided by GA in Docket No. 2011-229-WS. (Hipp Rehearing Direct, p. 477, ll. 13-14).

As set out in the Management Agreement and confirmed through cross examination of Mr. Guastella by the POAs and ORS, and in response to questions from the Commissioners, the Management Agreement entitles GA to the following:

1. a management fee of \$13,596.85 a month (\$163,162 annually) with an annual 3.5% increase;
2. a finance fee of 2% of the principal amount of any loan or GA’s actual total hourly rates for handling the loan, whichever is greater;
3. a capital fee of 10% for the first \$50,000 of construction and 8% for construction costs over \$50,000;
4. an annual incentive fee of 20% of the total net utility operating income;
5. an incentive fee if DIUC is sold;
6. rate case expenses;



7. travel expenses; and
8. expenses related to regulatory investigations and proceedings.

POA witness Lanier testified that the Commission should not allow DIUC to use its higher expenses related to GA to justify the need for a rate increase, given that the GA Management Contract expenses allow for an inflation-based increase of 3.5% per year, whereas the actual inflation rate over the last three years was less than 2.0% per year. (Lanier Direct, R. pp. 432-433).

#### Commission Decision

Upon review of the evidence, the Commission adopts ORS's adjustments for management fees. We agree that GA provides services to the ratepayers, but disagree that the services are at a level that warrant the amount set forth in the management services contract. We think it is appropriate for DIUC stockholders to have responsibility for the difference. While customer service complaints are few in number, this Commission did hear testimony at the night hearing and the merits hearing that GA was an absentee management company and had very little presence on the island. It is undisputed that DIUC did not pay property taxes under GA's tenure (resulting in the tax sale described above), that required regulatory reports and fees have been filed and paid late (R. p. 244), and that the South Carolina Department of Health and Environmental Control (DHEC) issued a notice of violations against DHEC (Vogel Direct, R. p. 319, ll. 14-16). We conclude the ORS-recommended amount for management expenses strikes a reasonable balance.

Moreover, and as we explained in Order No. 2016-50, although expenses of a public utility are presumed to be reasonable when incurred in good faith, the presumption does not

apply to affiliate payments. When payments are made by a regulated public utility to an affiliate, mere showing of actual payment does not establish a prima facie case of reasonableness. Clearly, DIUC and its management company GA are affiliates, as per the Management Agreement (Hearing Exhibit 9). (An “affiliate” is defined by Black’s Law Dictionary Free Online Legal Dictionary 2nd edition as “Companies that have a shared resources, interests, or business dealings.”) Further evidence of affiliation between GA and DIUC is shown in the Utility’s 2014 Annual Report to the Commission and ORS. John Guastella, the Managing Member of Guastella Associates, LLC, has been a member of the Board of Directors of DIUC since July 9, 2008.<sup>11</sup> Further evidence of Mr. Guastella’s membership on the DIUC Board of Directors is found at page 227 of the Transcript of the Hearing Record, wherein Mr. Guastella admitted that he was still a DIUC Board of Directors member at the time of his testimony in this case, and in similar testimony in the Rehearing.

The following interchange between Mr. Guastella and Commissioner Bockman is clearly demonstrates the affiliation between his company and DIUC:

Q: You tell [majority DIUC shareholder and President, Terry Lee] what to do, or he tells you what to do?

A. [Guastella] I pretty much tell him what to do....

(Rehearing R. p. 206).

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<sup>11</sup> The Company’s 2014 Annual Report on file with the Commission is deemed to be part of the Company’s Application, which is part of the record of this case, pursuant to the procedures set out by the South Carolina Code of Laws. See S.C. Code Ann. Regs. 103-512.4.A15, 103-712.4.A.15 and S.C. Code Ann. Section 1-23-320 (G) (3) (Supp. 2015).

Additionally, as discussed at the Hearing and the Rehearing, several of the provisions of the Management Agreement suggest less than an arm's length relationship between DIUC/DIUC Holding Company and GA. For example, Article V. "Termination" allows GA to terminate the Management Agreement "without cause by giving the Company sixty (60) days advance written notice ...." However, the same Article V does not extend the same "termination for convenience" right enjoyed by GA to the Clients, but instead allows only termination "for cause." DIUC's total inability to cancel the Management Agreement for any reason other than "for cause" is particularly significant in light of the Management Agreement's *automatic* renewal every three years. The combination of these two provisions creates an inequity between DIUC and Guastella Associates that shows who controls whom. Additionally, Mr. Guastella testified at the Rehearing 1) he drafted the Management Agreement and presented same to the Clients (Rehearing R. p. 168); 2) there was little if any negotiation of the Management Agreement (Rehearing R. p. 197); and 3) generally the Clients answer to GA (with respect to construction matters, for example), rather than a situation where GA answers to the Clients. (Rehearing R. p. 206).

Finally, the payment of unexplained expenses to affiliates does not entitle a regulated water and sewer utility to a requested increase in rates and charges. The rule is that if there is an absence of data and information from which the reasonableness and propriety of the services rendered and the reasonable cost of rendering such services can be ascertained by the Commission, allowance is properly refused. *Hilton Head Plantation Utilities, Inc. v. The Public Service Commission of South Carolina*, 312 S.C. 448, 441 S.E.2d 321 (1994). This language from the *Hilton Head Plantation Utilities* case requires the PSC to review and analyze these

intercompany dealings and determine if they are reasonable. *Kiawah Property Owners Group v. The Public Service Commission of South Carolina*, 338 S.C. 92, 525 S.E. 2d 863 (1999). Again, ORS found no apparent increases in the amount of management services provided by GA since the last rate proceeding, and, accordingly, recommended that no increased amount be granted in the present case, and this Commission adopted the ORS finding. Since the Company did not provide a reasonable explanation for its request for an increase in this area, the extra expense was properly denied.

#### Property Taxes

DIUC and the ORS agreed upon an adjusted expense amount for “Property Taxes” of \$188,093. (Revised Rehearing Audit Exhibit DFS-4) (Rehearing Exhibit 8). The POAs testified that the annual Property Taxes as adjusted due to a reduced rate base would equal \$59,213. (Exhibit LML-R2, Schedule WP-1) (Rehearing Exhibit 6). The POAs also testified that taxes for previous years would decrease from a total of \$526,844 to \$164,894. (Lanier Rehearing Direct R. p. 374, ll. 14-15).

#### Commission Decision

Because we agree with the POAs that DIUC’s rate base must be reduced to reflect CIAC, we also agree with the Property Tax adjustments proposed by the POAs. The POAs also recommended a means through which DIUC could recover property taxes it is obligated to pay, and which cannot be altered through amended returns to the S.C. Department of Revenue, via a surcharge which would be authorized by the Commission, following DIUC’s efforts to reduce its property tax burden through amended returns which would reflect lower plant balances and CIAC credits. (Lanier Rehearing Direct, R. p. 375-376). In view of the magnitude of the

property taxes and the impact on revenue requirements and rate levels, this appears to be a reasonable approach and the Commission accepts this recommendation.

Rate Case Expenses

DIUC seeks total rate case expenses of \$794,210 (\$674,210 actually incurred through September 2017, plus \$120,000 projected to complete the rehearing phase) to be amortized over three years. (Guastella Rehearing Rebuttal, R. p. 85, ll. 10-12). In addition, DIUC, seeks recovery of \$60,782 in bond costs, also to be amortized over a period of three years. (Guastella Rehearing Rebuttal, R. p. 77, l. 4).

The ORS recommends that DIUC be allowed to recover \$272,832 of the total requested \$794,210 in rate case expenses. ORS did not include \$88,999 in unsupported rate case expense. (Hipp Rehearing Direct Testimony, R. p. 474, ll. 18-20). In addition, ORS recommends that rate case expenses be recovered over a period of five (5) years because that amortization period is a “reasonable balance between the shareholders and ratepayers . . .” (Hipp Rehearing Direct, R. p. 476-477).

In support of the ORS decision to disallow \$542,878 in rate case expenses requested by DIUC, ORS witness Hipp testified regarding the criteria the ORS applied to ensure that invoices supplied by DIUC and supporting documentation included for ratemaking meet “known and measurable” standards:

- 1) The invoice is mathematically correct;
- 2) The invoice is for a valid business purpose;
- 3) The expense was incurred during the period under review;

4) The invoice was properly recorded on the books and records of the Company; and

5) The invoice was paid by the Company.

(Hipp Rehearing Direct, R. p. 474). The GA invoices supplied by DIUC failed to meet these standard criteria because they 1) contain mathematical errors; 2) Do not contain sufficient detail to describe the work performed, the specific dates and hours of work, employee name, and business purpose; 3) Contain expenses such as air fare, lodging, and meals for which no detail and or receipt was provided; and, 4) Do not appear to be paid by DIUC. (Hipp Rehearing Direct, R. p. 476, ll.11-18).

The POAs incorporated rate case expense of 364,600, amortized over 5 years, as shown on LML Exhibit LML-R3, Schedule C-5 (Rehearing Exhibit 6), consisting of \$289,600 in prior rate case expense and \$75,000 in current rate case expense.

The Commission agrees with ORS's judgment that \$ 272,832 in rate case expenses is a reasonable amount to pass to ratepayers for this rate case. The ORS criteria are standard and uniform, and applied with respect to every regulated utility and in every rate case. We also agree that the amortization period and the inclusion of unamortized rate case expenses from the last rate case are reasonable. The reasons set forth for excluding the non-allowable expenses is based on sound rate-making principals and those costs should not be passed to ratepayers. In addition, our analysis and application of the *Hilton Head Plantation Utilities* case described above, in view of the affiliation between DIUC and GA, further supports our decision to adjust the rate case expenses recovered by DIUC.

It is easy to see why sound ratemaking principles require denial of rate case expenses that are inadequately documented and unpaid. Rate case expenses can materially raise a utility's

revenue requirement and, accordingly its rates. Here, DIUC's requesting rate case expenses of approximately \$800,000, amortized over three years, *dramatically* increase the utility's proposed rates. It would be easy for a utility to inflate its asserted revenue requirement with unpaid and undocumented expenses, with the (stated or unstated) intent it would only pay those expenses if and when the Commission approves them as part of the utility's new rate structure.

#### Bad Debt Expense

The Company proposes adjusted bad debt expense of \$108,349 (Exhibit GCW-R1, Rehearing Exhibit 3), and ORS proposes adjusted bad debt expense of \$105,383, based on a negative adjustment of \$284 to the Company's per books amount from its original filing of \$105,667. (Revised Rehearing Audit Exhibit DFS-4, Rehearing Exhibit 9, based on the calculation of bad debt employed by ORS witness Gearheart in Exhibit ICG-4 in the Hearing).

The POAs propose bad debt expense of \$14,762. In its Application, DIUC's actual test year bad debt expenses were listed as \$105,667. Excluding "Misc. Other Revenues," that amount of bad debt expense is 10.1% of DIUC's revenue. According to POA witness Lanier, "[s]uch a rate of bad debt expense is unheard of and simply cannot be justified." (Lanier Rehearing Direct, R. p. 366, ll. 2-3). Significantly, this amount is also far in excess of the \$25,423 the Company proposed in its 2012 rate case, which ORS then adjusted down to \$9,332 (1.3% on revenues of \$714,996) (ORS Witness C. Stutz, Audit Exhibit CAS-1, Page 1 of 2).

In the present case, DIUC reduced its actual test year bad debt expenses (of \$105,667) by \$90,905, and proposed bad debt expense of \$14,762 (approximately 1.37% of its adjusted annual revenues of \$1,085,421). ORS provided testimony (in the original case and in this Rehearing) proposing to adjust that expense upward to \$105,384, adjusting the DIUC actual test year amount

(\$105,667) by \$284. (Revised Rehearing Audit Exhibit DFS-4) (Rehearing Exhibit 8). As set out in her Audit Exhibit ICG-4 (p.3 of 9) adopted by Mr. Sullivan, Ms. Gearheart applied a rate of 9.816% [DIUC's per book bad debt expense (\$105,668) as a percentage of its annual revenue (\$1,076,463)] multiplied by the ORS pro forma adjusted revenues of \$1,073,577, to arrive at the amount of \$105,384.

In contrast, Mr. Lanier's Exhibit LML-R3 (Rehearing Exhibit 6) calculates bad debt expense based on a composite rate of 1.36% of total revenues (0.5% of rate revenues and 2.5% of availability fee billings), arriving at bad debt expense of \$6,676 of the Water System and \$8,086 for the Sewer System, for a total of \$14,762, exactly what DIUC requested in its original application.

The Commission adopts the bad debt expense of \$14,762 proposed by the POAs. The composite rate of 1.36% of total revenues and the methodology used by POA witness Lanier is just and reasonable, in part because it encourages DIUC to collect those debts it is owed. Moreover, this percentage of bad debt expense was utilized previously for DIUC by the ORS in Docket No. 2011-329-WS, and we see no reason to approve a bad debt expense that almost 8 times that amount in this case. And the fact that DIUC recognized the reasonableness of this amount when it filed this rate case also supports this figure.

#### Other Adjustments

The remaining ORS adjustments are accepted by this Commission without discussion. They either were not disputed by the parties or were caused by carrying out the effects of the adjustments adopted above.

#### Performance Bond



DIUC is currently providing the maximum amount required for its performance bond in the amount of \$350,000 for water and \$350,000 for sewer operations. Using the criteria set forth in 10 S.C. Code Ann. Regs. 103-512.3.1 and 103-712.3.1, ORS recommended that DIUC be required to continue the current performance bond amounts. DIUC and the POAs did not challenge the performance bond amounts. Accordingly and pursuant to S.C. Code Ann. § 58-5-720 and 10 S.C. Code Ann. Regs. 103-512.3 and 103-712.3, the Commission requires that DIUC maintain its performance bond in the amount of \$350,000 for water and \$350,000 for sewer operations.

The Commission finds, based on the testimony of DIUC, the POAs and ORS, that an increase in rates is supported by the evidence presented. DIUC has not applied for a rate increase in several years as it was prevented from doing so pursuant to the settlement agreement approved in its last rate case in Docket No. 2011-229-WS. Expenses have increased during the last four years, and the Company is entitled to a fair and reasonable return to: 1) allow it to serve its customers at the same level and 2) place it in a more favorable position to borrow or acquire capital.

After reviewing the evidence in this case, approve the Rates in Attachment A [No Rate Schedule Attached]. The Rates revenue amount produces an operating margin of 2.6%. Further, the 9.31% ROE was recommended by the ORS. These rates will permit the Company to cover operating costs and provide an opportunity to earn the approved rate of return on rate base. The resulting ROE allows DIUC the opportunity to earn a fair return and are in the public interest.

## **V. FINDINGS OF FACT**

1. DIUC is a water and sewer utility providing water and sewer service in its assigned service area on Daufuskie Island, Beaufort County, South Carolina. The Commission is vested with authority to regulate rates of every public utility in this state and to ascertain and fix just and reasonable rates for service. S.C. Ann. §58-5-210, *et. seq.* DIUC's operations in South Carolina are subject to the jurisdiction of the Commission.

2. The Company provides service to 462 customers on Daufuskie Island, South Carolina.

3. The Company's prior rates were approved in Docket No. 2011-229-WS.

4. As of the original Hearing date, the Company had rate schedules relating to its water and sewer charges, broken down into residential and commercial rate classes and further into water, sewer, and irrigation charges. The Company's base quarterly residential water service charge was \$62.09 in the Haig Point Subdivision and \$80.72 in the Melrose Subdivision, with consumption charges of \$2.76 per thousand gallons (Haig Point) and \$2.44 per thousand gallons for consumption over 22,500 gallons per quarter (Melrose). The Company's base quarterly residential sewer service charge was \$110.38 in the Haig Point Subdivision and \$80.72 in the Melrose Subdivision, with volumetric charges of \$1.32 per thousand gallons (Haig Point) and volumetric charges of \$1.95 per thousand gallons over 22,500 gallons per quarter (Melrose). The Company's tap fees were \$500 for both water and sewer for residential customers. (Company Application, Statement of Proposed Rates).

5. The rates that the Company proposed, and that the Company has been charging since July 1, 2016, are found in the Company's Statement of Proposed Rates. In lieu of

discussing all of the proposed changes in the Company's rate schedules, the Commission will highlight the changes initially requested in the Company's residential service rates and terms of service. The Company initially proposed, and is currently charging under bond, pursuant to S.C. Code Ann. § 58-5-240(E), a base quarterly water charge of \$149.30 (for both Haig Point and Melrose), and quarterly consumption charges of \$4.41 per thousand gallons (for both Haig Point and Melrose). Likewise, the Company initially proposed, and is currently charging, a base quarterly sewer charge of \$218.18 (for both Haig Point and Melrose), and a quarterly volumetric charge of \$2.38 per thousand gallons.

6. The Company's Rehearing Testimony purports to include a "Statement of Proposed Rates." (Exhibit GCW-R1) (Rehearing Exhibit 3). The Commission agrees with ORS witness Hipp that these "proposed rates" are different from and exceed the Proposed Rates that were noticed to the public and to the customers of DIUC.

7. Under the Company's rates approved in Docket No. 2011-229-WS, the Company stated that its operating revenues for the test year were \$1,073,581. (Exhibit GCW-R1) (Rehearing Exhibit 3).

8. DIUC requested in its Application to increase revenues for combined operations by \$1,182,301, consisting of a water revenue increase of \$590,454, and a sewer revenue increase of \$591,847, based on the rate of return on rate base methodology utilizing an ROE of 10.5% and a 2014 historical test year.

9. The appropriate test year period for this proceeding, selected by the Company, is January 1, 2014 through December 31, 2014.

10. The Commission will use the return on rate base methodology in determining and fixing just and reasonable rates.

11. The return on rate base methodology requires three components: capital structure, cost of debt, and cost of equity (or return on equity).

12. The Commission adopts and approves the following as it sets forth a fair return along with just and reasonable rates.

13. Donated plant should be removed from rate base according to NARUC treatment of Contributions In Aid of Construction (CIAC). This consists of \$1,757,399 of gross water plant and \$2,656,660 of gross sewer plant.

14. The Commission shall utilize a capital structure of 46% long-term debt and 54% equity; a cost of debt rate of 5.29%; and an ROE of 9.31%.

15. The ROE of 9.31% produces additional operating revenue of \$219,993 consisting of a water revenues increase of \$169,694 and a sewer revenue increase of \$50,928. (Exhibit LML-R3, Schedule C-4) (Rehearing Exhibit 6).

16. We hereby set DIUC's rate base at \$2,304,944.

17. The approved revenues and expenses establish a fair and reasonable operating margin of 2.6%. S.C. Code Ann. § 58-5-240(H).

## **VI. CONCLUSIONS OF LAW**

Based upon the Discussion, Findings of Fact as set forth herein, and the record of the instant proceeding, the Commission makes the following Conclusions of Law:

1. DIUC is a public utility as defined in S.C. Code Ann. § 58-5-10(3) and as such is subject to the jurisdiction of this Commission.

2. The "Statement of Proposed Rates" included in the Company's Rehearing Testimony (Exhibit GCW-R1, Rehearing Exhibit 3) are not properly before the Commission

pursuant to S.C. Code Ann. § 58-5-240(B), and the Commission cannot consider or approve these rates.

3. The appropriate test year on which to set rates for DIUC is the twelve month period ending December 31, 2014.

4. Based on the information provided by the parties, the Commission concludes the appropriate rate setting methodology to use as a guide in determining the lawfulness of DIUC's proposed rates and for the fixing of just and reasonable rates is return on rate base.

5. In order for DIUC to have the opportunity to earn the 9.31% ROE, found fair and reasonable herein, DIUC must be allowed additional revenues of \$219,993.

6. The rates as set forth in the attached Order Attachment No. 1 [Rates Not Provided] are approved for use by DIUC and are designed to be just and reasonable without undue discrimination and are also designed to meet the revenue requirements of DIUC.

7. Pursuant to S.C. Code Ann. § 58-5-720 and 10 S.C. Code Ann. Regs. 103-512.3 and 103-712.3, DIUC shall post a performance bond of \$350,000 water and \$350,000 for sewer operations.

8. Pursuant to S.C. Code § 58-5-240(E), the Company is hereby Ordered to report to the Commission and to the parties the total amount of revenues that it has collected under the Proposed Rates, as well as the total amount of revenues that it would have collected based upon the rates ordered hereby, during the time period that the Proposed Rates were in effect.

IT IS THEREFORE ORDERED THAT:

1. The proposed rates, fees, and charges in Order Attachment 1 [Attachment One Not Provided] are both fair and reasonable and will allow DIUC to continue to provide its customers with adequate water and wastewater services.
2. The Company is to provide thirty (30) days' advance notice of the implementation of these rates to customers of its water and wastewater services prior to the rates and schedules being put into effect for service rendered. The schedules shall be deemed to be filed with the Commission pursuant to S.C. Code Ann. § 58-5-240.
3. A return on equity of 9.31% and operating margin of 2.6%, based on the new rates, fees, and charges, is approved for DIUC.
4. The Company shall continue to maintain current performance bonds in the amounts of \$350,000 for water operations and \$350,000 for wastewater operations pursuant to S.C. Code Ann. § 58-5-720.
5. The Company's books and records shall be maintained according to the National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts. The Company is directed to make any necessary adjustments to its accounting system to conform to the NARUC Uniform System of Accounts.
6. Pursuant to S.C. Code § 58-5-240(E), the Company is hereby Ordered to report to the Commission and to the parties the total amount of revenues that it has collected under the Proposed Rates, as well as the total amount of revenues that it would have collected based upon the rates ordered hereby, during the time period that the Proposed Rates were in effect.

7. This Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

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Swain E. Whitfield, Chairman

ATTEST:

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Randy Randall, Vice-Chairman